



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

State Capitol
Nashville, Tennessee 37243-0260
(615) 741-2501

John G. Morgan
Comptroller

December 19, 2006

Memorandum

TO: Governor Phil Bredesen

Chairman Douglas Henry, Jr.
Senate Finance, Ways, & Means Committee

Chairman Craig Fitzhugh
House Finance, Ways, & Means Committee

FROM: John Morgan, Comptroller of the Treasury *JM*
Riley Darnell, Secretary of State *RD*
Dale Sims, State Treasurer *DS*
M.D. Goetz, Jr., Commissioner
Department of Finance & Administration *MDG*

SUBJECT: Revenue Estimates for FY 2006-07 and FY 2007-08

The State Funding Board met on December 15 and December 19, 2006 to hear presentations on, and to engage in discussions about, the State's near-term economic outlook for the fiscal years 2006-07 and 2007-08. During this meeting, the Board heard economic testimony from Dr. William Fox of The University of Tennessee, Dr. Albert DePrince of Middle Tennessee State University, Dr. Jeff Wallace and Dr. Richard Evans of the University of Memphis, Mr. Jim White and Mr. Robert Currey of the Fiscal Review Committee, and Mr. Reid Linn of the State Department of Revenue. The state tax revenue estimates provided by each of the presenters are summarized in two attachments to this memorandum.

The Board is charged with responsibility to develop consensus ranges of state revenue growth. In doing so, the Board evaluates and interprets economic data and

revenue forecasts supplied by various economists as well as persons acquainted with the Tennessee revenue system. Since this is a revenue estimation process and **not** a budgeting process, the Board does not take into consideration the State's fiscal situation when developing its consensus ranges of revenue growth. Fiscal considerations properly belong with those who set the State's revenue estimates - the Administration that recommends appropriation levels based upon its assessment of revenue growth and the General Assembly that adopts a *de facto* revenue estimate through its final action on the appropriations bill.

The consensus is that growth in the economy has slowed. Although the presenters anticipate a moderate pickup in the economy in calendar year 2007, in response to anticipated adjustment to the fed funds rate, a consensus was not reached as to the timing of the growth. Tennessee's growth in non-agricultural employment has slowed and has dropped below the national average; there has been negative growth in both durable and non-durable goods sectors. (It was noted that supply chain technology has disrupted the historical inventory correction pattern.) The unemployment rate is down, but those who are unemployed remain unemployed for longer periods of time (especially those without post secondary education).

Tennessee's tax system continues to depend upon healthy growth in sales tax collections. Such growth is in turn dependent on growth in per capita income resulting in increased discretionary income. Tennessee is experiencing a slow down in big ticket sales (such as for automobiles), negatively impacting sales tax collections.

Presenters acknowledged the negative impact from the price of gas and heating oil (particularly on corporate profits) and the weakness in housing starts. The demand for construction (materials and labor) needed for hurricane reconstruction has driven up construction costs. The State has benefited from increased tax collections due to the growth in this sector during the past few years; however, the State cannot count on such continued incremental growth over the short-term.

Presenters acknowledged the unpredictability of the franchise and excise taxes (not unique to Tennessee). Volatility in these taxes have not been linked to any economic indicators. Reference was made to the taxes' life cycle: state tax law changes are made to improve the base; corporate taxpayers create new ways to avoid the taxes; and the legislature becomes faced again with the need to make changes to close loopholes.

The presenters cautioned that historically, inverted yield curves preceded recessions; however, the current inverted yield curve may not be an absolute indicator. Both franchise and excise taxes collections and the international trade imbalance between exports and imports caused the presenters some uneasiness with respect to their forecasts.

In terms of state revenue forecasts, all presenters believed the state would meet budget estimates (or only slightly undercollect) in fiscal year 2006-07. Note, estimates

from four of the five presenters for total revenue growth range in fiscal year 2006-07 from 3.37% to 4.31% and in fiscal year 2007-08, from 3.20% to 4.37%; the fifth presenter's estimate of 6.38% and 5.66% respectively is not included.

Based on the testimony received and the Board discussions, the Board developed the following summarized consensus estimates expressed in ranges of growth rates in State tax revenue collections:

	FY 2006-07		FY 2007-08	
	Low	High	Low	High
Total State Taxes	3.20%	3.70%	3.80%	4.30%
General Fund Only	2.95%	3.45%	4.05%	4.55%

The Board believes these consensus revenue growth ranges to be reasonable and appropriate for use in state budgeting. Note, the ranges for fiscal year 2006-07 are to be applied to a higher beginning base (than anticipated in May 2006) resulting from overcollection of revenues in the prior fiscal year. As in past years, the Board intends to revisit these estimates prior to the General Assembly's final budget deliberations. Each of you will be advised of any revisions made by the Board at that time.

Additionally, the State Funding Board received presentations regarding the Tennessee Education Lottery (TEL). Legislation in 2003 created the Tennessee Education Lottery Corporation (TELC) (Tennessee Code Annotated Sections 4-51-101 et seq.). Tennessee Code Annotated Section 4-51-111(c) requires the Board to establish a projected revenue range for the "Net Lottery Proceeds" [defined in Section 4-51-102(14)] for the remainder of the current fiscal year and for the succeeding fiscal year. Mr. Robert Currey, Chief Economist, with the Fiscal Review Committee (FRC) presented the Board the FRC's projections. Mr. Currey reviewed the fiscal year 2005-06 performance of the TEL and reported \$269,863,000 in Net Lottery Proceeds. In looking at fiscal year 2006-07, Mr. Currey noted more moderate growth for the instant games and that growth experienced has been due to greater payouts. Lotto 5 actually experienced negative growth (-5.3%). He additionally forecasted negative growth for Powerball due to last year's significant jackpot growth. Mr. Currey referenced the "sweet spot" or the optimum prize expense point after which subsequent increases to the prize payout ratio will have no or negative effect (the incremental revenue is less than the incremental increase in expenses) (law of diminishing returns). His assumptions include two new games (Hot Trax and a raffle-type game) and expenses at 73% rather than 72% as used in May 2006.

For fiscal year 2007-08, the FRC projected a 2.5% overall net sales growth. The Net Lottery Proceeds available for deposit into the Education Account for fiscal years 2006-07 and 2007-08 are anticipated to be 27% of Net Revenue.

The Board additionally heard from Ms. Rebecca Paul Hargrove, the Chief Executive Officer and Mr. Andy Davis, Chief Financial and Technology Officer of the TELC. The TELC is continuing to estimate approximately 2% of prizes (excluding jackpot prizes) to be the amount for unclaimed prizes; 100% of which is to be deposited into the "after school programs special account" at the end of each fiscal year. Note, this amount was changed by legislation the last session.

Ms. Hargrove stated that TELC agreed with FRC's assumptions used in estimating lottery revenues and confirmed that net lottery proceeds are estimated to be 27% of net revenues for both fiscal years.

The Board then heard from Mr. David Wright, Assistant Director for Policy Planning and Research, of the Tennessee Higher Education Commission, and from Mr. Tim Phelps, Associate Executive Director for Grants and Scholarship Programs, of the Tennessee Student Assistance Corporation. In fiscal year 2005-06, there were 56,058 awards in the TEL Scholarship program, with an actual cost of \$136,844,971. Mr. Phelps lowered the fiscal year 2006-07 projections to 59,750 awards, with a projected cost of \$172,000,000. Mr. Wright presented estimates for fiscal year 2007-08 (representing a fully mature program with no growth in first time freshmen) of 68,300 awards, with a projected cost of \$211,200,000. These awards include all lottery-funded scholarship programs.

The estimates provided by each of the presenters are summarized in an attachment to this memorandum. Consensus was reached on the following estimates of the range for net proceeds of lottery revenues to be deposited in the Lottery for Education Account, to be used for the various statutory purposes:

	FY 2006-07		FY 2007-08	
	Low	High	Low	High
Net Lottery Proceeds	\$268,600,000	\$275,400,000	\$274,000,000	\$282,300,000

Although the volatility of lottery sales contrasts with the recurring nature of scholarships, the Board noted that estimates of net lottery proceeds for both fiscal years exceed the current estimate of a fully mature scholarship program. Unclaimed prize money (up to \$18 million) is available for afterschool programs; excess net lottery proceeds (available after funding scholarship requirements and reserves) are available for pre-K programs.

Tennessee Code Annotated Section 4-51-111(c)(2)(B) states:

Before December 15, 2003, and before December 15 in each succeeding year, appropriate state agencies shall submit to the funding board and to the governor their recommendations for other educational programs and purposes consistent with article XI, § 5 of the Tennessee Constitution based on the difference between

the funding board's projections and recommendations for the lottery scholarship program based on the report submitted pursuant to subdivision (c)(2)(A). In no event shall such recommendations exceed the projections of the funding board for a specific fiscal year.

Attached is a copy of the letter received pursuant to this statutory section.

The estimates of the net lottery proceeds will be revisited at the time the State Funding Board considers revisions to the ranges of State revenue estimates prior to the adoption of the State's Appropriations Act. As indicated previously, each of you will be advised of any revisions made by the Board at that time.

Each of us stands ready to discuss this further at your convenience.

Attachments

Revenue Estimates (2)
Lottery Estimates
TSAC Report
Funding Request Letters (1)

cc. The Honorable John S. Wilder
The Honorable Jimmy Naifeh

**COMPARISON OF ESTIMATED STATE TAX REVENUE FOR
FISCAL YEAR 2006-2007**

(Accrual - Basis Estimates)

2006-2007													
DEPARTMENT OF REVENUE	2005-2006 ACTUAL ACCRUAL	BUDGETED ESTIMATE	% CHANGE OVER 05-06 ACTUAL	DR. FOX ESTIMATE	% CHANGE OVER 05-06 ACTUAL	FISCAL REVIEW ESTIMATE	% CHANGE OVER 05-06 ACTUAL	DR. DePRINCE ESTIMATE	% CHANGE OVER 05-06 ACTUAL	DR. EVANS ESTIMATE	% CHANGE OVER 05-06 ACTUAL	REVENUE DEPT. ESTIMATE	% CHANGE OVER 05-06 ACTUAL
SOURCE OF REVENUE													
Sales and use Tax	\$ 6,515,643,000	\$ 6,805,300,000	4.45%	\$ 6,795,800,000	4.30%	\$ 6,829,156,000	4.81%	\$ 6,801,200,000	4.38%	\$ 6,928,000,000	6.33%	\$ 6,810,000,000	4.52%
Gasoline Tax	605,598,900	597,000,000	-1.42%	596,500,000	-1.50%	608,640,000	0.50%	599,000,000	-1.09%	611,000,000	0.89%	606,100,000	0.08%
Motor Fuel Tax	180,653,200	184,300,000	2.02%	187,000,000	3.51%	187,104,000	3.57%	186,500,000	3.24%	194,000,000	7.39%	185,200,000	2.52%
Gasoline Inspection Tax	64,519,700	65,500,000 *	1.52%	65,100,000	0.90%	64,938,000	0.65%	66,800,000 *	3.53%	66,000,000	2.29%	65,600,000	1.67%
Motor Vehicle Registration Tax	249,541,000	255,000,000	2.19%	258,200,000	3.47%	258,275,000	3.50%	256,300,000	2.71%	257,000,000	2.99%	255,500,000	2.39%
Income Tax	194,367,900	203,500,000	4.70%	206,100,000	6.04%	207,974,000	7.00%	219,400,000	12.88%	219,000,000	12.67%	204,300,000	5.11%
Privilege Tax - Less Earmarked Portion	304,889,400	307,900,000	0.99%	317,100,000	4.00%	307,900,000	0.99%	309,800,000 (1)	1.61%	337,000,000 (1)	10.53%	313,900,000	2.96%
Gross Receipts Tax - TVA	220,325,400	228,000,000	3.48%	247,500,000	12.33%	247,482,000	12.33%	228,000,000 **	3.48%	247,000,000	12.11%	247,500,000	12.33%
Gross Receipts Tax - Other	20,841,400	21,800,000	4.60%	19,000,000	-8.84%	23,000,000	10.36%	17,900,000	-14.11%	23,000,000	10.36%	21,800,000	4.60%
Beer Tax	17,797,300	17,900,000 *	0.58%	18,000,000	1.14%	18,153,000	2.00%	18,200,000 *	2.26%	19,000,000	6.76%	17,900,000	0.58%
Alcoholic Beverage Tax	39,208,200	39,900,000 *	1.76%	39,800,000	1.51%	39,992,000	2.00%	40,700,000 *	3.80%	42,000,000	7.12%	40,200,000	2.53%
Franchise & Excise Taxes	1,491,616,000	1,531,000,000	2.64%	1,491,600,000	0.00%	1,542,947,000	3.44%	1,567,500,000	5.09%	1,611,000,000	8.00%	1,515,500,000	1.60%
Inheritance and Estate Tax	76,287,700	71,000,000 *	-6.93%	77,000,000	0.93%	81,628,000	7.00%	72,400,000 *	-5.10%	83,000,000	8.80%	76,900,000	0.80%
Tobacco Tax	124,872,300	125,000,000 *	0.10%	124,900,000	0.02%	125,497,000	0.50%	127,400,000 *	2.02%	127,000,000	1.70%	125,800,000	0.74%
Motor Vehicle Title Fees	10,989,800	11,400,000 *	3.73%	11,200,000	1.91%	11,300,000	2.82%	11,600,000 *	5.55%	11,000,000	0.09%	11,400,000	3.73%
Mixed Drink Tax	49,054,900	51,500,000 *	4.96%	52,000,000	6.00%	52,489,000	7.00%	52,500,000 *	7.02%	51,000,000	3.97%	51,500,000	4.98%
Business Tax	121,663,200	124,200,000 *	2.09%	127,800,000	5.04%	124,705,000	2.50%	126,600,000 *	4.06%	118,000,000	-3.01%	124,200,000	2.09%
Severance Tax	1,754,100	1,400,000 *	-20.19%	1,800,000	2.62%	1,500,000	-14.49%	1,400,000 *	-20.19%	2,000,000	14.02%	1,400,000	-20.19%
Coin Operated Amusement Tax	304,400	300,000 *	-1.45%	300,000	-1.45%	300,000	-1.45%	300,000 *	-1.45%	0	NA	300,000	-1.45%
Unauthorized Substance Tax	830,200	400,000 *	-51.82%	800,000	-3.64%	1,000,000	20.45%	400,000 *	-51.82%	1,000,000	20.45%	400,000	NA
TOTAL DEPARTMENT OF REVENUE	\$10,290,758,000	\$10,642,300,000	3.42%	\$10,637,500,000	3.37%	\$10,733,980,000	4.31%	\$10,703,900,000	4.01%	\$10,947,000,000	6.38%	\$10,675,400,000	3.74%
GENERAL FUND ONLY (2)	\$ 3,622,222,100	\$ 3,905,000,000	3.28%	\$ 3,884,300,000	3.04%	\$ 3,966,280,000	3.99%	\$ 3,954,900,000	3.86%	\$ 3,916,200,000	6.27%	\$ 3,916,800,000	3.42%
Budgeted Est. Compared to New Est. - Total				-\$4,800,000		\$91,680,000		\$61,600,000		\$304,700,000		\$33,100,000	
Budgeted Est. Compared to New Est. - Gen. Fund				-\$20,700,000		\$61,280,000		\$49,900,000		\$257,900,000		\$11,800,000	

SELECTED TAXES	ACTUAL	BUDGETED	%	DR. FOX	%	FISCAL REVIEW	%	DR. DePRINCE	%	DR. EVANS	%	REVENUE DEPT.	%
SALES AND USE TAX	\$ 5,515,643,000	\$ 6,805,300,000	4.45%	\$ 6,795,800,000	4.30%	\$ 6,829,156,000	4.81%	\$ 6,801,200,000	4.38%	\$ 6,928,000,000	6.33%	\$ 6,810,000,000	4.52%
FRANCHISE AND EXCISE TAXES	1,491,616,000	1,531,000,000	2.64%	1,491,600,000	0.00%	1,542,947,000	3.44%	1,567,500,000	5.09%	1,611,000,000	8.00%	1,515,500,000	1.60%
INCOME TAX	194,367,900	203,500,000	4.70%	206,100,000	6.04%	207,974,000	7.00%	219,400,000	12.88%	219,000,000	12.67%	204,300,000	5.11%
ROAD USER TAXES	1,100,312,800	1,101,800,000	0.14%	1,106,800,000	0.59%	1,118,957,000	1.69%	1,108,600,000	0.75%	1,128,000,000	2.52%	1,112,400,000	1.10%
ALL OTHER TAXES	988,818,300	1,000,700,000	1.20%	1,037,200,000	4.89%	1,034,946,000	4.66%	1,007,200,000	1.86%	1,061,000,000	7.30%	1,033,200,000	4.49%

(1) Privilege Tax estimates are reduced by \$32 million for the earmarked portion of the tax.

(2) F&A calculated the General Fund distribution for all presenters.

* F&A distributed taxes for Dr. DePrince based on ratios for budgeted collections for 2006-2007.

** F&A distributed the Gross Receipts Taxes for Dr. DePrince based on anticipated TVA collections in 2006-2007.

**COMPARISON OF ESTIMATED STATE TAX REVENUE FOR
FISCAL YEAR 2007-2008**

(Accrual - Basis Estimates)

DEPARTMENT OF REVENUE	DR. FOX	% CHANGE	FISCAL REVIEW	% CHANGE	DR. DePRINCE	% CHANGE	DR. EVANS	% CHANGE	REVENUE DEPT.	% CHANGE
SOURCE OF REVENUE	ESTIMATE	OVER 06-07 ESTIMATE	ESTIMATE	OVER 06-07 ESTIMATE	ESTIMATE	OVER 06-07 ESTIMATE	ESTIMATE	OVER 06-07 ESTIMATE	ESTIMATE	OVER 06-07 ESTIMATE
Sales and use Tax	\$ 7,149,200,000	5.20%	\$ 7,119,395,000	4.25%	\$ 7,020,300,000	3.22%	\$ 7,345,000,000	6.02%	\$ 7,116,800,000	4.51%
Gasoline Tax	596,500,000	0.00%	611,683,000	0.50%	605,300,000	1.05%	617,000,000	0.98%	612,000,000	0.97%
Motor Fuel Tax	193,600,000	3.53%	191,782,000	2.50%	192,900,000	3.43%	208,000,000	7.22%	189,200,000	2.16%
Gasoline Inspection Tax	65,500,000	0.61%	66,237,000	2.00%	68,300,000 *	2.25%	67,000,000	1.52%	66,700,000	1.68%
Motor Vehicle Registration Tax	266,000,000	3.02%	264,732,000	2.50%	259,800,000	1.37%	262,000,000	1.95%	260,100,000	1.80%
Income Tax	216,400,000	5.00%	210,054,000	1.00%	241,300,000	9.98%	234,000,000	6.85%	213,000,000	4.26%
Privilege Tax - Less Earmarked Portion	336,100,000	5.99%	314,058,000	2.00%	328,800,000 (1)	6.13%	374,000,000 (1)	10.98%	322,700,000	2.80%
Gross Receipts Tax - TVA	260,500,000	5.25%	253,669,000	2.50%	228,000,000 **	0.00%	253,000,000	2.43%	251,600,000	1.66%
Gross Receipts Tax - Other	19,400,000	2.11%	23,920,000	4.00%	21,900,000	22.35%	25,000,000	8.70%	22,400,000	2.75%
Beer Tax	18,300,000	1.67%	18,516,000	2.00%	18,700,000 *	2.75%	19,000,000	0.00%	18,000,000	0.56%
Alcoholic Beverage Tax	41,400,000	4.02%	40,992,000	2.50%	41,600,000 *	2.21%	45,000,000	7.14%	41,400,000	2.99%
Franchise & Excise Taxes	1,536,300,000	3.00%	1,573,806,000	2.00%	1,617,900,000	3.22%	1,716,000,000	6.52%	1,526,900,000	0.75%
Inheritance and Estate Tax	73,000,000	-5.19%	82,444,000	1.00%	74,100,000 *	2.35%	85,000,000	2.41%	78,700,000	2.34%
Tobacco Tax	126,100,000	0.96%	125,497,000	0.00%	130,400,000 *	2.35%	129,000,000	1.57%	127,700,000	1.51%
Motor Vehicle Title Fees	11,300,000	0.89%	11,583,000	2.50%	11,900,000 *	2.59%	12,000,000	9.09%	12,000,000	5.26%
Mixed Drink Tax	55,200,000	6.15%	55,113,000	5.00%	53,700,000 *	2.29%	54,000,000	5.88%	54,500,000	5.83%
Business Tax	134,200,000	5.01%	128,446,000	3.00%	129,500,000 *	2.29%	119,000,000	0.85%	126,800,000	2.09%
Severance Tax	1,800,000	0.00%	1,500,000	0.00%	1,500,000 *	7.14%	2,000,000	0.00%	1,400,000	0.00%
Coin Operated Amusement Tax	300,000	0.00%	300,000	0.00%	300,000 *	0.00%	0	NA	300,000	0.00%
Unauthorized Substance Tax	800,000	0.00%	1,200,000	20.00%	400,000 *	0.00%	1,000,000	0.00%	400,000	NA
TOTAL DEPARTMENT OF REVENUE	\$11,101,900,000	4.37%	\$11,094,927,000	3.36%	\$11,046,600,000	3.20%	\$11,567,000,000	5.66%	\$11,042,600,000	3.44%
GENERAL FUND ONLY (2)	\$ 9,309,700,000	4.79%	\$ 9,296,327,000	3.68%	\$ 9,263,900,000	3.45%	\$ 9,732,000,000	6.21%	\$ 9,251,200,000	3.75%
Growth over FY 07 Budgeted Est. - Total	\$459,600,000		\$452,627,000		\$404,300,000		\$924,700,000		\$400,300,000	
Growth over FY 07 Budgeted Est. - Gen. Fund	\$404,700,000		\$391,327,000		\$358,900,000		\$827,000,000		\$346,200,000	
SELECTED TAXES	DR. FOX	%	FISCAL REVIEW	%	DR. DePRINCE	%	DR. EVANS	%	REVENUE DEPT.	%
SALES AND USE TAX	\$ 7,149,200,000	5.20%	\$ 7,119,395,000	4.25%	\$ 7,020,300,000	3.22%	\$ 7,345,000,000	6.02%	\$ 7,116,800,000	4.51%
FRANCHISE AND EXCISE TAXES	1,536,300,000	3.00%	1,573,806,000	2.00%	1,617,900,000	3.22%	1,716,000,000	6.52%	1,526,900,000	0.75%
INCOME TAX	216,400,000	5.00%	210,054,000	1.00%	241,300,000	9.98%	234,000,000	6.85%	213,000,000	4.26%
ROAD USER TAXES	1,121,600,000	1.34%	1,134,434,000	1.38%	1,126,300,000	1.60%	1,154,000,000	2.30%	1,128,000,000	1.40%
ALL OTHER TAXES	1,078,400,000	3.97%	1,057,238,000	2.15%	1,040,800,000	3.34%	1,118,000,000	5.37%	1,057,900,000	2.39%

(1) Privilege Tax estimates are reduced by \$32 million for the earmarked portion of the tax.

(2) F&A calculated the General Fund distribution for all presenters.

* F&A distributed taxes for Dr. DePrince based on ratios for budgeted collections for 2006-2007.

** F&A distributed the Gross Receipts Taxes for Dr. DePrince based on anticipated TVA collections in 2006-2007.

State Funding Board
Net Lottery Proceeds Estimates
Actual 2005-2006 and Estimated 2006-2007 and 2007-2008
December 19, 2006

	2005-2006 Actual	2006-2007 Revised	%	2007-2008	%
Lottery Corporation					
Low	269,863,000	268,600,000	-0.47%	274,000,000	2.01%
High	269,863,000	272,900,000	1.13%	278,400,000	2.02%
Mid-Range Estimate	269,863,000	270,750,000	0.33%	276,200,000	2.01%
Fiscal Review Staff					
Low	269,863,000	263,540,000	-2.34%	270,220,000	2.53%
Median	269,863,000	270,046,000	0.07%	276,877,000	2.53%
High	269,863,000	275,416,000	2.06%	282,366,000	2.52%
Recommended Range					
Low	269,863,000	268,600,000	-0.47%	274,000,000	2.01%
High	269,863,000	275,400,000	2.05%	282,300,000	2.51%